Pentti Hakkarainen: Minimise the use of public money through the Banking Union

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the 15th Integrated Financial Supervisors Conference, Copenhagen, 25 June 2013.

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Thank you very much for inviting me today to this conference here in Copenhagen. It is a pleasure to speak on such an extremely timely topic like the Banking Union.

As we all know, finance ministers did not reach a political compromise on the bank recovery and resolution directive yet on Friday/Saturday. We should hear positive news on the bank recovery and resolution directive (BRRD), which is an important milestone in the road towards the Banking Union. Moreover, we are waiting also for the final vote on the Single Supervisory Mechanism by the European Parliament in early July. I hope this timetable will hold so that we can proceed well with the preparations to kick-off the single supervisory system in 2014.

Why a Banking Union?

Let me start with the question why it has been necessary to establish the Banking Union and the Single Supervisory Mechanism (SSM) as its key component?

The crisis since 2008 has made it clear that a highly interconnected and integrated euro area requires a stronger institutional framework than what we currently have. A problem at one bank can quickly spread to other banks both at home and beyond national borders with devastating effects on the real economy and taxpayers. Furthermore, this crisis led to a sudden stop of capital flows within Europe, as banks withdrew within national borders and financial integration took serious setbacks.

An important element to strengthen the financial institutional framework is the creation of the Banking Union. The agreement to establish the SSM has been reached at a record pace. A strong and independent supranational supervisor is needed to ensure the smooth functioning of the monetary union and to restore confidence in the banking sector. The key element in confidence rebuilding is the balance sheet assessment of banks to be conducted before the SSM is up and running and timely action, if necessary, on potential weaknesses in banks' balance sheets. The idea is that legacy asset problems should be detected and potential capital shortages corrected before the operational start of the SSM and shifting of the supervisory responsibility to the European Central Bank (ECB).

Credibility of national supervision has suffered because of three reasons. First, national mandates of the supervisors lead to inability to handle cross-border challenges. Second, the so called regulatory capture i.e. close relationships between banks and the supervisor led at instances to slow reactions or unwillingness to react at all to noticed problems in banks. Third, a suspicion of political influences in supervision has weakened the standing and credibility of supervisors. Moreover, in 2010 it became desperately evident that the bank and sovereign risks are tightly interconnected and with two-way causality. The establishment of the SSM will be a major step forward and can help to address these shortcomings but, alone, will not be sufficient. Single supervision needs to be accompanied with a system and powers to restructure and wind down failing banks while minimizing the cost to taxpayers. This is also the main thrust in the Financial Stability Board's (FSB) key attributes of resolution. This is more or less what the Banking Union is about. The regaining of confidence in the banking sector is the key to reverse recent developments towards financial fragmentation and help re-establish a well-functioning interbank market and capital flows. These are of key importance also for restoring economic growth and the single market programme.

The overall Banking Union framework – key elements

SLIDE: Key elements of the Banking Union

The first element is the Single Rule Book. The EU has the objective of developing a Single Rule Book, which is based on the idea of maximum harmonization of basic regulatory requirements (such as capital adequacy rules) while leaving leeway for national authorities to impose stricter requirements nationally for systemic stability and macro-prudential reasons. The Single Rule Book for banking is based on CRR/CRD4/deposit guarantee directive and the upcoming bank recovery and resolution directive and is complemented by the binding standards issued by the European Banking Authority (EBA). The EBA has the legal competence to develop and monitor the implementation of the Single Rule Book.

The EBA also has the task in moving ahead with the harmonization of supervisory practices. The SSM will have to develop strongly harmonized supervisory practices ("Supervisory Manual") in order to create a single system – also extended to smaller banks. It is expected that the SSM Manual will be significantly more detailed than the EBA's Handbook, but the two will need to be consistent and therefore close cooperation has been already started between the SSM and the EBA.

The establishment of the SSM is the second element of the Banking Union. The SSM will be a unitary supervisory system, composed of national competent authorities and the ECB – and close cooperation between them – and with the possibility of non-euro area Member States to participate. The ECB will assume direct supervisory responsibility and major decision making powers for significant banks meeting certain criteria. We expect the number of such banks to reach some 130–140.

I will discuss the SSM more in detail in a while. Before that, let me go to the third element of the Banking Union which should be the establishment of a Single Resolution Mechanism (SRM). An important pre-condition for this would be a swift adoption of the Bank Recovery and Resolution Directive (BRR), as it lays out a harmonised toolbox of resolution powers. The Single Resolution Mechanism would build on the measures and tools laid down in the Directive, particularly by providing a robust framework that allows for prompt and coordinated resolution action, specifically where cross-border banks are concerned. An efficient resolution mechanism including the possibility to bail-in bank debt-holders is a key element in the new policy objective to have bail-in as the predominant tool in resolution and limit the use of bail-outs as far as possible. In the new regime, bail-in should be the rule, bail-out the rare exception.

As we all know, the swift and orderly resolution of cross-border banks is the Achilles heel that needs to be addressed. For this purpose, one needs to move from national to supranational arrangements for significant banks. I do not need to remind that this would be particularly important for the highly integrated Nordic banking market.

The draft BRR requires that national resolution authorities cooperate with each other and that resolution colleges are established from all the resolution authorities of the countries where the bank has business operations. However, the draft BRR or any other existing arrangements do not contain compulsory coordination of resolution measures before they are taken by home and host authorities. Hence, there is no explicit and binding resolution mechanism for cross-border banks. Conflicts of interest and incentives for geographical ring-fencing that have plagued cross-border crisis management in previous cases will still be embedded in the current framework. Both home and host authorities can exercise ring-fencing at their own discretion.

It is doubtful that a resolution college could effectively coordinate in time the necessary decisions involved in the resolution of a cross-border banking group and resolve the conflicts of interest. We will need the establishment of the SRM with good decision making procedures and – hopefully in the longer run – a European Resolution Authority to implement successfully the resolution process across the countries participating in the SSM. In the absence of the SRM, the ECB would have to hand problem banks back to national authorities that could also create conflicts of interest as national authorities could disagree with the measures taken on the supervisory side and deviate from a desired course when exercising resolution.

The SRM should have the same institutional and geographical scope as the SSM. Ideally, and in the longer run, there should be the Single Resolution Authority, which would be at the centre of the SRM, govern the resolution of banks and coordinate the application of resolution tools. It should have a comprehensive set of enforceable tools, powers and authority to resolve all banks in the SSM. In particular it would ensure that failing banks are resolved swiftly, through impartial decision-making focused on the European dimension. The timely resolution of banks should avoid the cascading of problems from one bank to other banks, thereby affecting European financial stability.

In my view, the banking union can be established without simultaneous creation of the pan-European deposit guarantee scheme (DGS). Harmonisation of national DGS and their use could already be sufficient step forward, including the ex ante collection of funds from banks into the deposit guarantee funds.

Key features of the planned supervisory mechanism

SLIDE: Timeline for the establishment of the SSM

If all goes well, the European Parliament should vote on 7 July and the SSM regulation could enter into force in the beginning of August this year – meaning that the actual operation of the SSM could start in August 2014, and then the ECB could assume its direct supervisory duties.

The SSM will operate as a system, catering for all expertise of national supervisors and at the same time possessing a strong decision-making centre. Appropriate decentralisation procedures are being planned, while preserving the unity of the supervisory system and avoiding duplication. The SSM, with the ECB at its centre, is entrusted with an extensive set of micro- and macro- prudential powers, covering all key tasks relating to the prudential supervision of credit institutions. This broad array of tasks and powers is crucial, as it is the foundation for the SSM to effectively supervise banks.

The SSM also possesses early intervention powers as they are foreseen in the draft BRR. These early intervention powers are significant relating the governance and scope of activities of institutions that start to have serious problems that can lead them to a point of non-viability.

To ensure a strong centre, the ECB’s overall responsibility for supervision within the SSM is matched by control powers over the system as a whole, as well as by very close cooperation arrangements with national authorities. What makes the SSM work truly as one system, besides the legal competence over all the banks, are the following main features:

- First, all the components of the system will have to act in accordance with a system of guidelines, ECB specific regulations and manuals of supervisory practices.
- Second, the ECB supervisory function, at the centre, will receive all the supervisory data, regarding all the banks.
- Third, the bodies at the center of the system, at the ECB supervisory function, have the power to overtake the direct supervision of any bank or group of banks that may be considered relevant and may be the origin of systemic risk.
- Fourth, the center supervises and monitors that overall supervisory quality is followed by national competent authorities.

In practice, a risk-based approach to supervision will be adopted. Joint Supervisory Teams will be established that will integrate ECB and national competent authority (NCA) staff into single supervisory units responsible for the conduct of the on-going supervisory activities and for preparing supervisory decisions. The Teams will be established and coordinated by ECB; there will likely be one Team for each significant banking group, but tailored to the needs of each banking group (proportionality).

A common SSM Risk Assessment System is being developed, which relies on an integrated and harmonized information base. The System will be used for addressing the capital and liquidity needs of banks in the SSM and also to direct supervisory resources (e.g. inspections' planning) on the basis of the risk- and impact assessment.

The supervision of Nordic banking groups – such as Nordea or Danske Bank – is interesting from our perspective and in particular should the home-country authorities of these groups remain outside of the SSM. In this situation, the ECB will assume the responsibility of a host supervisor of the major subsidiaries in the Euro Area which also are significant banks on their own and will enter into the SSM supervision.

SLIDE: Supervision of Nordea in the Banking Union

Take Nordea as example. The supervisory college will continue to operate under Swedish leadership as before to coordinate the overall supervisory activities and form the picture of risks, capital and liquidity at the group level. As a new element the ECB will participate in the supervisory college as the responsible authority for the Euro Area subsidiaries, while the present host authorities from Finland and Estonia will still join supervisory cooperation on their behalf; which is important also to maintain full picture of financial stability in their respective countries. Should differences in opinion emerge; the EBA will mediate between the home authority and the ECB. The picture would become different, should Sweden and Denmark decide to join the SSM. It would simplify the supervisory structure if all our Nordic authorities would operate under the SSM roof.

The SSM also has powers in the macro-prudential area, which is a shared competence with national macro-prudential authorities. The ECB will comment on national measures and has the possibility to tighten the national measures if they are deemed inadequate. Macro-prudential instruments could also be applied to the euro-area financial system as a whole, in addition to individual countries. The crisis has shown that supervising the micro-prudential risks at individual banks separately is not sufficient and that macro- and micro- risks can actually be mutually reinforcing. There has to be very close cooperation between the macro- and micro-prudential functions.

The shared competence is important for two reasons. First, the system needs to be established in a way that creates incentives for action, ie the pre-crises prevailed national inaction bias needs to be broken. Second, the credit cycles differ nationally and the associated potential problems need to be mitigated through nationally diverging ways. This is a different approach compared with monetary policy in monetary union or banking supervision, in which the aim is maximum harmonization of national practices.

Key milestones in the preparation of the SSM

SLIDE: Key milestones in the preparation of the SSM

The practical preparation of the SSM has been well underway since last autumn. In this summer the main elements of the supervisory model and the supervisory manual should be rather developed. The same goes for the ECB Framework Regulation, which is an own regulation by the ECB setting out the main responsibilities of the ECB and national authorities and the main requirements set for banks in the SSM. Also during this summer the main features of the SSM Risk Assessment System (RAS) should be available as well as the finalized list of significant banks entering into SSM direct supervision.

During this autumn 2013 and spring 2014 the newly established SSM Supervisory Board first consults on and then adopts all the basic documents setting out the operation of the SSM, which would then start in the summer of 2014. I would like to emphasize that the Supervisory Board is the main body responsible for the supervisory functions of the SSM and the main decision making body, even decisions are formally and finally adopted by the Governing Council of the European Central Bank. When it comes to the role of the Governing Council, it cannot alter the decisions of the Supervisory Board, but only prevent their entry into force if such a veto power is exercised, and only if strongly justified e.g. by monetary policy reasons. Hence, in the decision making as well as in the internal ECB organization, separation of the monetary policy and supervisory functions will be realized. During 2013 and 2014 also the ECB supervisory organization will be staffed and start their operation.

Of particular relevance for the credible start of the SSM will be the Balance Sheet Assessment (BSA) –project, making sure that all major problems in asset quality are well-known and sufficiently addressed before the operational start of the SSM. The BSA will also link with pan-European stress tests conducted in close cooperation between the EBA and the SSM during spring 2014. I believe it is in the interest of the countries which are not joining the SSM from the beginning, to follow the same level of standards in their own asset quality reviews as applied within the SSM.

Non-Euro area countries joining the SSM (Member States in close cooperation)

SLIDE: Member States in close cooperation

National competent authorities of non-euro area Member States have an option to participate in the SSM. They can participate through establishing a close cooperation agreement with the ECB. By giving non-euro area Member States full membership and voting rights in the Supervisory Body, the body responsible for the preparation of decisions on supervisory matters, they are placed on an equal footing with euro-area Member States.

While the ECB Governing Council is the ultimate decision-making body of the ECB, its role in the SSM is reduced to the possibility of accepting or rejecting the decisions of the Supervisory Board. This was accepted at the level of the European Council by all governments which seem to indicate that we might see an extension of the SSM well beyond the euro area.

Joining the SSM would mean that the supervisory processes of the SSM would be applied also to non-euro area banks. This would give the benefit of streamlining and unifying supervisory processes for major cross-border banks.

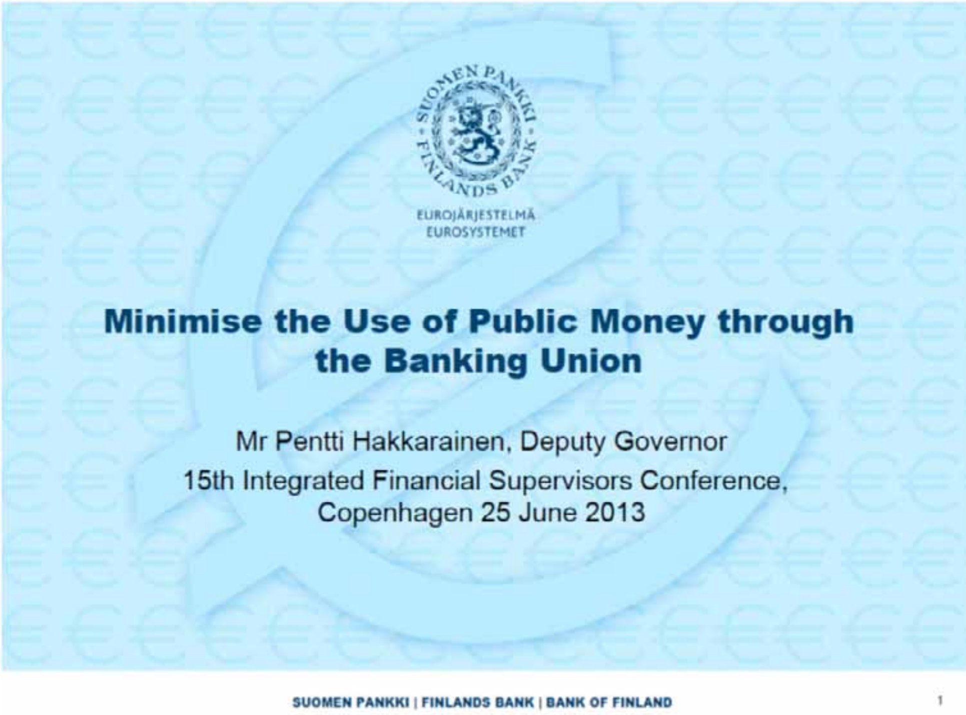
The special status of the non-Euro Area countries is taken into account in the decision-making mechanism. As I noted, the Governing Council enforces the decisions by the Supervisory Board. If the Council prevents the entry into force of a decision, which e.g. results in a modification of the decision, a non-EA country may announce non-satisfaction with such a decision. If the Council decision prevails, the non-EA country can choose not to adopt the decision. On its side then, the ECB could consider breaking-up the agreement for close cooperation

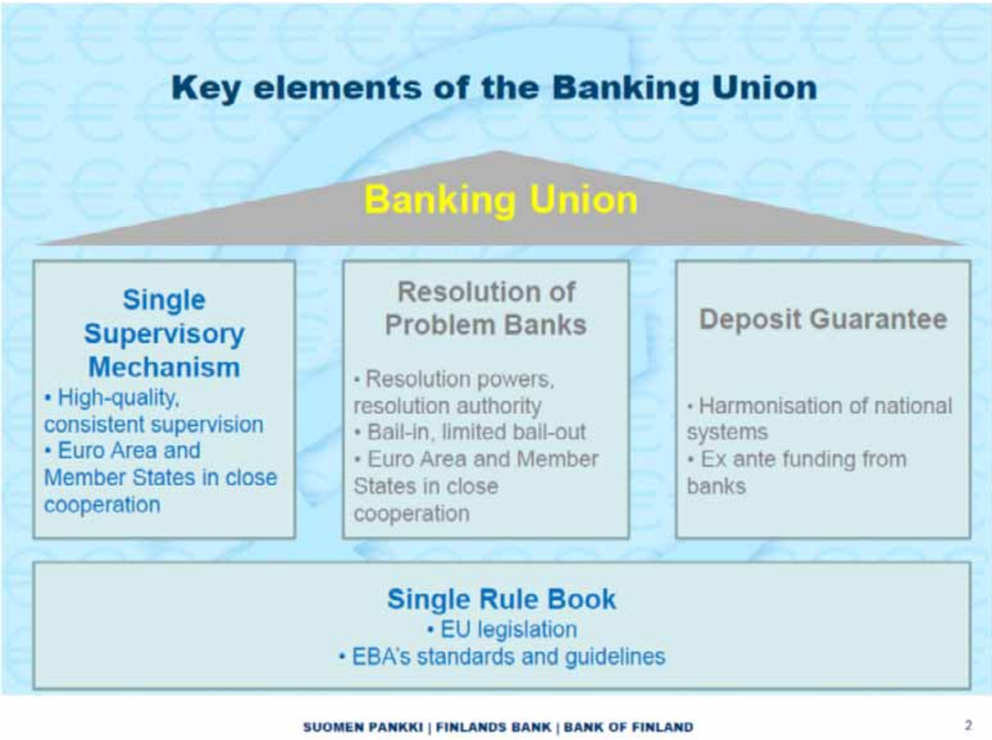
Closing

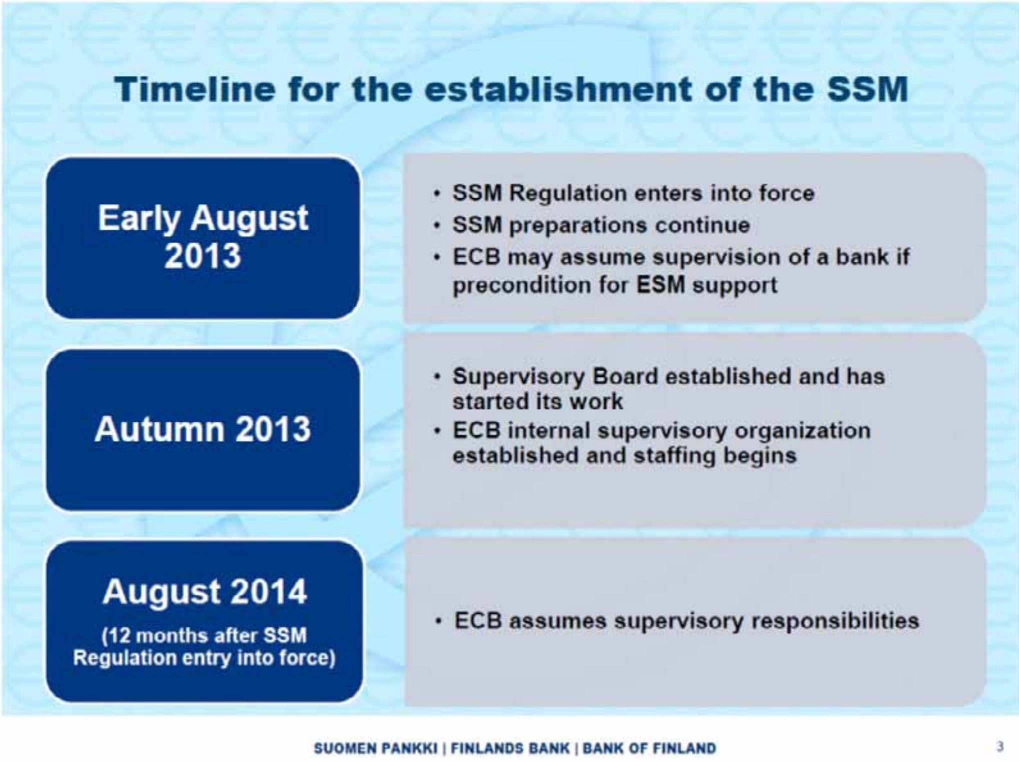
Ladies and gentlemen, let me conclude by saying that we are taking significant steps in our road towards the Banking Union. However, there are many steps ahead before we have reached the goal of a high quality and comprehensive pan-European supervision and resolution system. Creation of the SSM is steadily on track and we will soon see the Commission’s proposal on the SRM. It is worth to mention that the nature of supervision and resolution tasks are such that those should be kept in the hands of independent officials without political involvement. Such a system, with clear rules established for all participants, would greatly reduce the contingent liability placed on tax payers and reduce the presumption of bail-outs. I am convinced that these steps are worth taking and lead us towards an efficient and credible European framework.

If the financial crisis has taught us something, it is that that the sooner we identify potential problems and solve them, the less likely is the involvement of public money. A well defined and well functioning supervisory and resolution system is just about it!

Slides






Timeline for the establishment of the SSM
Early August 2013
• SSM Regulation enters into force
• SSM preparations continue
• ECB may assume supervision of a bank if precondition for ESM support
Autumn 2013
• Supervisory Board established and has started its work
• ECB internal supervisory organization established and staffing begins
August 2014
(12 months after SSM Regulation entry into force)
• ECB assumes supervisory responsibilities
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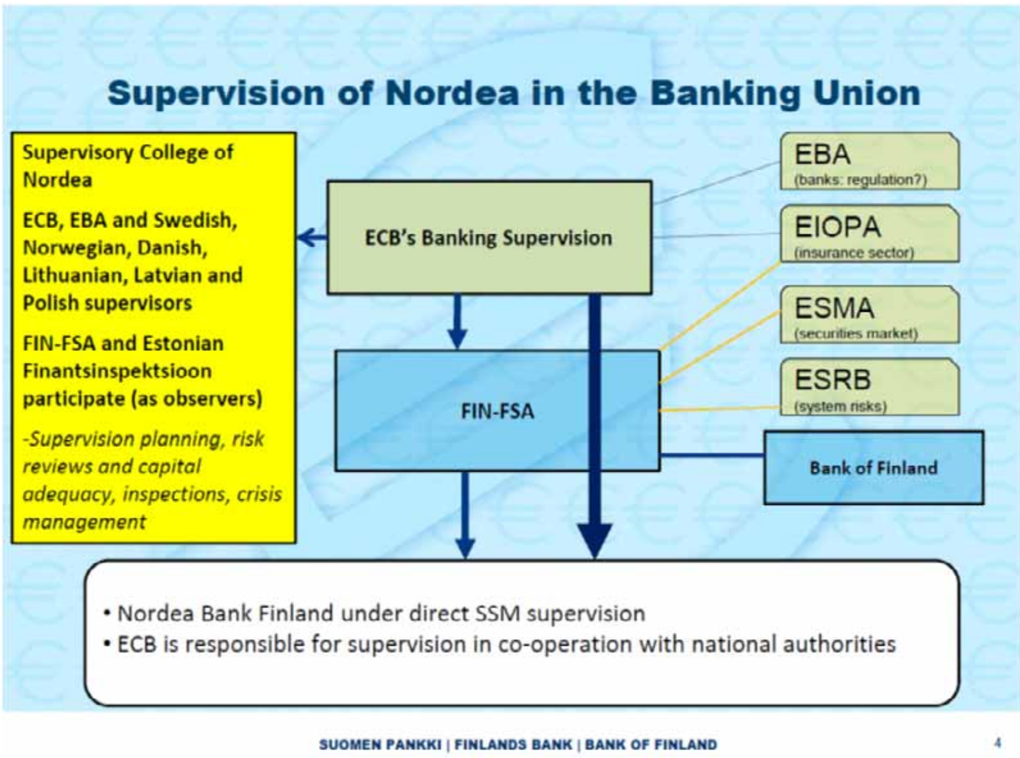
Supervision of Nordea in the Banking Union
Supervisory College of Nordea
ECB, EBA and Swedish, Norwegian, Danish, Lithuanian, Latvian and Polish supervisors
FIN-FSA and Estonian Finantsinspektsioon participate (as observers)
-Supervision planning, risk reviews and capital adequacy, inspections, crisis management
ECB's Banking Supervision
FIN-FSA
EBA
(banks: regulation?)
EIOPA
(insurance sector)
ESMA
(securities market)
ESRB
(system risks)
Bank of Finland
• Nordea Bank Finland under direct SSM supervision
• ECB is responsible for supervision in co-operation with national authorities
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Key milestones in the preparation of the SSM

- Summer 2013
  - Main elements of the Supervisory Model and ECB Framework Regulation
  - Main elements of the Risk Assessment System (RAS)
  - Selection criteria for significant banks
- Autumn 2013-Spring 2014
  - Supervisory Board first consults on and then adopts
    - Framework regulation
    - Supervisory Manual (supervisory processes and the RAS)
    - Supervisory reporting
  - List of banks falling under direct SSM supervision
  - Balance Sheet Assessment -project
  - Preparations for the start of the operational SSM supervision

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Member States in close cooperation

- EU countries from outside the Euro Area may join the Single Supervisory Mechanism
  - Non-EA countries may sign an agreement for close co-operation with the ECB allowing them to join the work of the SSM and the Supervisory Board
- The standing of such Members in close co-operation has been taken into account in the decision-making mechanism
  - Governing Council enforces the decisions by the Supervisory Board
  - If the Council prevents the entry into force of a decision, which e.g. results in a modification of the decision
    - A non-EA country may announce non-satisfaction with such a decision
    - The Council needs to explain its decision
  - If the Council decision prevails, the non-EA country can choose not to adopt the decision
    - The ECB could consider breaking-up the cooperation agreement

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